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Treaty Reform: Consequences for Monetary Policy

The proposed reform treaty, aimed at enhancing the efficiency and democratic legitimacy of the enlarged Union as well as its position on the global stage, has a number of important implications for monetary policy and the status of the European Central Bank. Can the reforms be expected to make euro area governance more efficient? Could they potentially jeopardise the ECB's independence and European monetary policy?

The purpose of this article is to discuss the issue of Treaty reform and its consequences for monetary policy. *Inter alia*, the changes include that the institutional set-up will be subtly changed and the European Central Bank (ECB) will be grouped in the first part of the Treaty as one of the "other institutions and advisory bodies". Possibly more importantly, the euro area as such will be in the position to act legally as itself within the European Union (EU) legal structures. The Euro-group also will be officially recognised ("Euro-Ecofin-Council"). The rules for enhanced cooperation have also been further relaxed from the Treaty of Nice, also applying to the area of economic governance (e.g. euro area coordination, tax policy, exchange rates). What should we think of these reforms? Will they make euro area governance more efficient and/or could they potentially jeopardise the ECB's independence and European monetary policy?

The Reform of the Treaty

In essence, the content of the new proposed reform treaty is very similar to that of the Treaty establishing a Constitution for Europe.¹ It has just been modified and rephrased, as many heads of the different EU governments have already confirmed. In July 2007, an Intergovernmental Conference (IGC) has been held to

discuss the "new" Treaty and to seek political support for all the amendments to the original treaties. The major changes proposed include the removal of the three-pillar structure of the EU, more democracy, changes to the institutional setup of the Union, improvement of the solidarity and security within the Union and enhancement of the position of the EU on the global stage.² The three-pillar structure³ will be abolished to simplify the structure of the EU. The structure will be reorganised, with more emphasis on foreign and security policy and justice and home affairs. More democracy will be realised by giving national parliaments and the European Parliament (EP) a bigger say, while the power of the European Commission will decrease. The EP will be on an equal footing with the Council of Ministers in many areas in terms of decision-making. A withdrawal option will be included, in order to state that member states are part of the EU by their own choosing. Moreover, there will be some opt-out options in the area of police and criminal law, as urged by the United Kingdom and the Czech Republic. The change in the institutional set-up of the ECB will be most important for the working of monetary policy and the status of the ECB. The latter effects will be singled out later in the text and treated in more detail. Furthermore, decision-making will take place more swiftly and more commonly be supported by the system of qualified majority voting, which will be introduced in more

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¹ OpenEurope.org.uk/research/guide.pdf.

² European Commission: Reforming Europe for the 21st Century, Communication from the Commission to the Council, COM (2007) 412 final, Brussels, 10 July 2007.

³ The European Communities pillar, the Common Foreign and Security Policy pillar and the Police and Judicial Cooperation in Criminal Matters pillar.

than forty new areas. This is also going to apply to economic governance. These measures include the relinquishing of veto power in many areas (including the ECB's powers over financial regulation), the appointment of a permanent President of the European Council, and a reinforcement of the Commission's authority. Also, it is easier to amend the treaty in the new form, by means of co-decision and qualified majority voting, so that a new IGC will not be necessary. This also includes amending the articles concerning the ECB and its independence, as we shall see below.

Consequences for European Monetary Policy and the ECB⁴

Article 107 (formerly III-187 of the Constitution) states that a number of Articles in the Statute of the European System of Central Banks can, for the first time, be amended by qualified majority voting, on a proposal from the Commission: "Articles 5.1, 5.2, 5.3, 17, 18, 19.1, 22, 23, 24, 26, 32.2, 32.3, 32.4, 32.6, 33.1(a) and 36 of the Statute of the ESCB may be amended by the European Parliament and the Council, acting in accordance with the ordinary legislative procedure."

These articles include significant ECB powers such as: the power to set minimum reserve requirements for banks and the power to fine financial institutions; the power to conduct foreign exchange operations and make international agreements for currency co-ordination; the power to set up and regulate clearing systems; and arrangements for sharing the profits of the ECB. The ultimate consequence of these changes may imply that the ECB's interest-rate policy could be neutralised by other EU institutions, like the EP and the Ecofin council. The Ecofin council could e.g. push the ECB to use (sterilised) exchange rate interventions, thus influencing more frequently the ECB's monetary policy.

This would give the EP and the Ecofin council more power and could affect the ECB's independence and monetary policy. It has to be noted that these amendments have to take place by co-decision and qualified majority voting. Qualified majority voting implies that not all countries have to be on board and that the larger countries have a relatively stronger voting position. The possible collusion between the larger countries (compare the collusion of France, Germany and Italy regarding the non-enforcement of the Stability

and Growth Pact in recent years) may undermine the supranational character of policy decision-making and increase the tensions within the eurozone between the larger and smaller countries.

Article 114 of the new Treaty (which was Article III-194 of the original Constitution) will make the Eurogroup – the informal meetings of finance ministers from eurozone countries – into a formal body with its own President, elected for two and a half years. This President may represent the eurozone in international financial organisations like the International Monetary Fund (IMF). The Eurogroup also gains the right to send recommendations to eurozone countries that are in breach of EU rules, and the power to decide (by majority voting) whether a non-eurozone country is ready to enter the euro area.

Representation in International Financial Institutions

Article 115a (ex-111(4)) (137)(III-196)

1. In order to secure the euro's place in the international monetary system, the Council, on a proposal from the Commission, shall adopt a decision establishing common positions on matters of particular interest for economic and monetary union within the competent international financial institutions and conferences. The Council shall act after consulting the European Central Bank.
2. The Council, on a proposal from the Commission, may adopt appropriate measures to ensure unified representation within the international financial institutions and conferences. The Council shall act after consulting the European Central Bank.
3. For the measures referred to in paragraphs 1 and 2, only members of the Council representing Member States whose currency is the euro shall take part in the vote.

These powers were already defined in the old Treaty, although this new article is wider in scope. The actions following from this article are subject to the new qualified majority voting procedure described in Article 205 (3)(a). It should be emphasised that this article, certainly the first part, is so vague ("of particular interest for economic and monetary union") that it may be easily misinterpreted and misused by the Council and other EU institutions. I would strongly advise revising this article to secure the ECB's independence.

⁴ The following section draws on the research of Open Europe published at www.OpenEurope.org.uk/research/guide.pdf.

Article 117 (ex-121(1), 122(2) and 123(5)) (139)

(...) "The Council shall act having received a recommendation of a qualified majority of those among its members representing Member States whose currency is the euro. These members shall act within six months of the Council receiving the Commission's proposal." The only substantive change here is the power of the eurozone countries to give a recommendation, separately from the rest of the Council, on whether a candidate for the eurozone is qualified to join it.

The Independence of the European Central Bank

Although *Article 108* of the Treaty still states that "neither the *European Central Bank*, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from *Union* institutions or bodies, from any government of a Member State or from any other body", the fact that the European Central Bank will be grouped with institutions such as the European Commission and the European Parliament affects its special status. This may have consequences for the functioning of the ECB in conducting effective monetary policy. The grouping of the ECB with other EU institutions will affect its independence; this must be considered an extremely dangerous development. President Jean-Claude Trichet⁵ emphasised rightfully that only the ECB's independence makes its monetary and exchange-rate policies credible and effective. Lorenzo Bini Smaghi, Executive Board Member of the ECB, mentioned the importance of central bank independence for credible and effective monetary policy.⁶ French President Nicolas Sarkozy⁷ seems to want to downgrade the independence of the ECB, so as to give the Council of Ministers (and therefore the Ecofin council) more power over monetary policy within the eurozone. In Table 1 an overview of opinions by central bankers, politicians and other opinion leaders is presented.

Trade-off between Central Bank Independence and Conservativeness

The Maastricht Treaty has made the ECB very independent. Nowadays it is widely believed that a high level of central bank independence and an explicit mandate for the bank to restrain inflation are important institutional devices to assure price stability. It is

thought that an independent central bank can give full priority to low levels of inflation. In countries with a more dependent central bank other considerations (notably, the re-election perspectives of politicians and a low level of unemployment) may interfere with the objective of price stability. In that context the German central bank is often mentioned as an example. The Deutsche Bundesbank was relatively autonomous; at the same time, Germany had one of the best post-Second World War inflation records among the OECD countries. Indeed, the statutes of the ECB are largely modelled on the law governing the Bundesbank.

Why would central bank independence, *ceteris paribus*, yield lower rates of inflation? The theoretical reasoning in this field stresses the "time inconsistency problem".⁸ The basic idea behind the time-inconsistency problem can be explained as follows. Suppose the policymaker announces a certain inflation rate that (s)he considers optimal. If private sector agents take this announced inflation rate into account in their behaviour, it becomes at that time optimal for the government to renege and to create a higher than announced inflation rate. The reason for this is that a burst of unexpected inflation yields certain benefits. For instance, unexpected inflation reduces real wages, thereby increasing employment.

Of course, this is only part of the story. The next step is to add rational expectations. Under rational expectations economic agents know government's incentive to create unexpected inflation and take this into account in forming their expectations. Government has no other choice than to vindicate these. It is clear that the inflation rate will be higher than under the situation in which the government stuck to its promise. No matter which factors exactly cause the dynamic inconsistency problem, in all cases the resulting rate of inflation is sub-optimal. Therefore in the literature devices have been suggested to reduce this "inflationary bias". Rogoff⁹ has proposed delegating monetary policy to an independent and "conservative" central banker. "Conservative" means that the central banker is more averse to inflation than the government, in the sense that (s)he places a greater weight on price stability than the government does.

⁵ Agence France Presse, 13 August 2007.

⁶ Lorenzo Bini Smaghi: The Future of the Treaty: implications for economic governance in Europe, speech, Frankfurt am Main, 5 July 2007.

⁷ The Daily Telegraph, 11 August 2007.

⁸ F. W. Kydland, E. C. Prescott: Rules Rather than Discretion: The Inconsistency of the Optimal Plans, in: *Journal of Political Economy*, Vol. 85, 1977, pp. 473-491; R. J. Barro, D. Gordon: Rules, Discretion, and Reputation in a Positive Model of Monetary Policy, in: *Journal of Monetary Economics*, Vol. 12, 1983, pp. 101-121.

⁹ K. Rogoff: The Optimal Degree of Commitment to an Intermediate Monetary Target, in: *Quarterly Journal of Economics*, Vol. 110, 1985, pp. 1169-1190.

Table 1
An Overview of Opinions by Central Bankers, Politicians and Other Opinion Leaders

The Independence of the European Central Bank	
<p><i>French President Nicholas Sarkozy</i> He has publicly criticised the position of independence of the ECB and tried to give the Council of Ministers more control over monetary policy. Sarkozy wants to see the policies of the bank oriented towards promoting growth and jobs in the euro-zone, rather than simply being focused on controlling inflation. (The Daily Telegraph, 17 August 2007)</p> <p>"Mr Sarkozy's criticism: politicians, not central bankers, should be in charge of exchange rate policy, as is the case in the US and most other countries, including Germany before 1999, and the euro's exchange rate should be actively managed to be competitive." (Wolfgang Münchau, Financial Times website, 1 July 2007)</p>	<p><i>German Chancellor Angela Merkel</i> She has supported the independence of the ECB after Sarkozy attacked it. "Of course one can talk, but ECB decisions are a matter for the bank's governing body alone," (Agence France Presse, 19 July 2007)</p> <p><i>Wolfgang Münchau, The Financial Times</i> "Sarkozy jeopardises the future of the euro area." Mr. Münchau criticises Sarkozy for wanting to reduce the independence of the central bank in conducting monetary policy, for wanting to control the exchange rate of the euro and for increasing the French government deficit instead of decreasing it. (Financial Times website, 1 July 2007)</p> <p><i>Joaquin Almunia, EU Economic and Monetary Affairs Commissioner</i> "Everyone has a right to his opinion on monetary policy and on interest rates but nobody should put pressure on the (central) bank," (Agence France Presse, 4 September 2007)</p> <p><i>Several EU Ministers of Finance</i> They support the ECB's independence and have clearly expressed their concerns about Sarkozy's statements (Europa NU, 9 May 2007).</p> <p><i>Lorenzo Bini Smaghi, ECB Executive Board Member</i> His critique is that in negotiating the new treaty there are still governments that want to "rebalance" economic powers (Speech, 5 July 2007).</p>
Treaty Reform with Respect to the European Central Bank and the Eurogroup	
<p><i>French President Nicholas Sarkozy</i> He seeks to increase the Council's power over monetary policy, and mainly the French government's power. This is made easier by the new draft Treaty. (The Daily Telegraph, 17 August 2007)</p> <p><i>UK Labour Government</i> Criticises the new Treaty for allowing the Eurogroup more power, while it does want the Council (and thus the UK) to have more power over euro area matters. This will of course jeopardise the position of the UK vis-à-vis eurozone countries. (Open Europe Guide to the Treaty, 16 August 2007)</p>	<p><i>ECB President Jean-Claude Trichet</i> He is concerned about the status of the ECB under the new Treaty and is afraid that by including the bank in a list of EU institutions there is a risk that EU member states could formulate policy recommendations to the ECB, an ECB spokesman explained.</p> <p><i>Open Europe Vice-Chairman Derek Scott</i> "France has always sought political control of the ECB: the new Treaty entrenches it." (Open Europe Press Release, 16 August 2007)</p> <p><i>Joaquin Almunia, EU Economic and Monetary Affairs Commissioner</i> "A central bank with an independent statute which feels under pressure would be liable to show that it is independent." (Agence France Presse, 4 September 2007)</p> <p><i>Pietro De Matteis, Founder "United For Europe"</i> Lowering ECB independence may lead to less credible monetary policy, and even to political pressure making the monetary policy only fit the policies of the big EU countries, leading to asymmetries. (TheNewFederalist.eu, 15 August 2007)</p>
Competition versus Protectionism	
<p><i>French President Nicholas Sarkozy</i> He managed to remove the reference to "free and undistorted competition" from the draft Treaty, as he does not see this as a target. (EurActiv.com, 2 July 2007)</p> <p><i>German Chancellor Angela Merkel</i> "It has been restructured, it hasn't been devalued," Merkel said, "since the free market is mentioned and the internal market is mentioned throughout this mandate." (EurActiv.com, 2 July 2007)</p>	<p><i>Open Europe Vice-Chairman Derek Scott</i> He opposed the change of the phrase "free and undistorted competition" and criticised Gordon Brown for being outmanoeuvred by Sarkozy in negotiations. (The Daily Telegraph, 11 August 2007)</p> <p><i>Daniel Gros, Director of the Centre for European Policy Studies (CEPS)</i> "(...) important is that, in the eurozone, competition is increasing, reaching markets that were previously protected, in large countries such as France, and this is what is upsetting a number of politicians." (EurActiv.com, 2 July 2007)</p>

Why would a central banker be more inflation averse than the government? Two main differences have been pointed out in the literature between the preferences of the government and those of the central bank.¹⁰ One relates to possible differences in the time preference of political authorities and that of central banks. For various reasons, central banks tend to take a longer view of the policy process than do politicians. The other difference concerns the subjective weights in the objective function of the central bank and that of government officials. It is often assumed that central bankers are relatively more concerned about inflation than about other policy goals such as achieving high employment levels and adequate government revenues. If monetary policy is set at the discretion of a "conservative" and independent central banker, a lower average time-consistent inflation rate will result.

The central insights of this literature can be explained as follows. It is assumed that policy-makers seek to minimise the following loss function (L), which represents the preferences of the society:

$$(1) L^G = \frac{1}{2} \pi_t^2 + \frac{\chi}{2} (y_t - y_t^*)^2$$

where y_t is output, y^* denotes desired output and χ is the government's weight on output stabilisation ($\chi > 0$). Output is driven by a simplified Lucas supply function:

$$(2) y_t = (\pi_t - \pi_t^e) + u_t$$

where π is actual inflation, π^e is expected inflation, and u_t is a random shock. Policymakers minimise (1) on a period by period basis, taking the inflation expectations as given. With rational expectations, inflation turns out to be:

$$(3) \pi_t = \chi y_t^* - \frac{\chi}{\chi + 1} u_t$$

The first term on the right hand side of equation (3) is the inflationary bias. A country with a high inflationary bias has a credibility problem, as economic subjects are aware of the government's incentives for surprise inflation. The second term in equation (3) reflects the degree to which the stabilisation of output shocks influences inflation. Suppose now that a "conservative"

central banker is put in charge of monetary policy. Conservative means that the central banker is more inflation averse than the government. The loss function of the central banker can therefore be written as:

$$(4) L^{cb} = \frac{1+\varepsilon}{2} \pi_t^2 + \frac{\chi}{2} (y_t - y_t^*)^2$$

where ε denotes the additional inflation aversion of the central banker. The preferences of the central banker do not matter, unless (s)he is able to determine monetary policy. In other words, the central bank should be able to pursue monetary policy without (much) government interference. This can simply be modelled as follows:¹¹

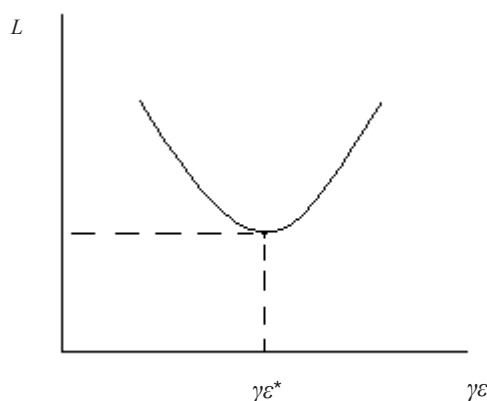
$$(5) M_t = \gamma L^{cb} + (1-\gamma) L^G$$

where γ denotes the degree of central bank independence, i.e. the extent to which the central banker's loss function affects monetary policy making. If $\gamma = 1$, the central bank fully determines monetary policy M . With rational expectations and minimising government's loss function, inflation will be:

$$(6) \pi_t = \frac{\chi}{1+\gamma\varepsilon} y_t^* - \frac{\chi}{1+\gamma\varepsilon+\chi} u_t$$

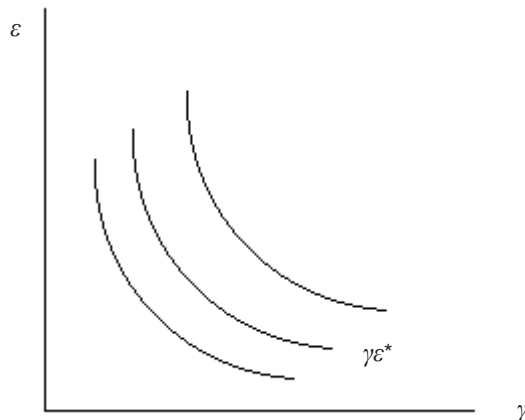
¹¹ S. C. W. Eijffinger, M. Hoeberichts: The trade off between central bank independence and conservativeness, in: Oxford Economic Papers, Vol. 50, 1998, pp. 397-411.

Figure 1
The Optimal Level of Central Bank Independence and Conservativeness



¹⁰ A. Cukierman: Central Bank Strategy, Credibility and Independence, Cambridge 1992.

Figure 2
Trade-off between Conservativeness and Independence of a Central Bank



Comparing equations (3) and (6), one can immediately see that the inflationary bias (the first term on the right hand of the equations) is lower for positive values of γ and ε . In other words, delegating monetary policy to an independent and “conservative” central bank will yield a lower level of inflation. There is an optimal level of independence cum conservativeness ($\gamma\varepsilon^*$). Under certain assumptions, this is shown graphically in Figure 1. Optimal means that the loss function of the society (eq. 1) is minimised.

It also follows from equation (6) that both independence and the inflation aversion of the central bank matter. If the central banker has the same inflation aversion as government (i.e. $\varepsilon = 0$), the independence does not matter. And similarly, if the central bank is fully under the spell of government (i.e. $\gamma = 0$), the conservativeness of the central bank does not matter. There are various combinations of γ and ε that may yield the same outcome, including the optimal one. We illustrate this in Figure 2.

From a practical point of view the concept of a “conservative” central banker seems, however, void, since the preferences of possible candidates for positions in the governing board of a central bank are generally not very easy to identify and may change after they have been appointed. It is therefore hard to find a real world example of a “conservative” central banker. Still, one could argue that the statute of the central bank could be relevant here, especially with respect to the question of whether or not it defines price stability as the

primary goal of monetary policy. Whether or not the statute of a central bank defines price stability as the primary policy goal can be considered as a proxy for the “conservative bias” of the central bank as embodied in the law.¹²

Conclusion

From a theoretical point of view it can thus be argued that an independent central bank may reduce the inflationary bias of monetary policy-making. What about the empirical evidence? A substantial amount of empirical research supports the inverse relationship between central bank independence and the level of inflation.¹³ The negative relationship between indicators of central bank independence and inflation in OECD countries is quite robust, even if various control variables are included in the regression. Still, it should be noted that a negative correlation does not necessarily imply causation. The correlation between both variables could be explained by a third factor, e.g. the culture and tradition of monetary stability in a country. However, sometimes central bank independence is a *condition sine qua non* to establish the culture and tradition of monetary stability in a country (e.g. in France).

President Jean-Claude Trichet’s concern about the status of the ECB under the new Treaty and his fear that by including the bank in a list of EU institutions there is a risk that EU member states could formulate policy recommendations to the ECB, is not only true, but may also lead to more conservativeness (inflation aversion) on the part of the ECB. Central bankers are like whipping cream: the more politicians stir them, the stiffer they become!

Politicians, such as President Sarkozy, should realise that their attempts to downgrade the ECB’s independence legally and verbally will only *increase* its conservativeness in order to maintain the *same* inflationary bias and limit the ECB’s degrees of freedom with respect to its interest-rate policy. The consequences of these attempts are relative *higher* interest-rates in the eurozone, exactly the opposite of what they wish to achieve.

Sometimes it is better to tie yourself, like Odysseus, to the mast in order to resist the siren song.

¹² A. Cukierman, op. cit.

¹³ Cf. S. C. W. Eijffinger, J. De Haan: The Political Economy of Central-Bank Independence, in: Princeton Special Papers in International Economics, No. 19, 1996.